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In the Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTION PRESENTED

Whether tax accrual workpapers, prepared by a corporation's independent certified public accountant in the course of regular financial audits, are privileged from disclosure in response to an internal revenue summons issued under 26 U.S.C. 7602.

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ARTHUR YOUNG & COMPANY, ET AL.[1]

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The order of the district court (App. A, *infra*, 1a-15a) is reported at 496 F. Supp. 1152. The opinion of the court of appeals (App. B, *infra*, 16a-39a) is reported at 677 F.2d 211.

JURISDICTION

The judgment of the court of appeals was entered on April 13, 1982 (App. C, *infra*, 40a). The order denying the government's petition for rehearing was entered on June 22, 1982 (App. D, *infra*, 41a). By order dated September 13, 1982,

[1] Amerada Hess Corporation was also a party below, and is a respondent, along with Arthur Young & Co. For the sake of clarity, however, "respondent" refers only to Arthur Young & Co.

Justice Marshall extended the time within which the United States may file a petition for a writ of certiorari to and including October 20, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The pertinent provisions of Sections 7601, 7602 and 7604 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in App. E, *infra*, 42a-43a.

STATEMENT

1. Respondent Arthur Young & Co., a firm of certified public accountants, has served as Amerada Hess Corporation's independent auditor since November 1971. In that capacity, respondent conducted financial audits of, and certified, Amerada's financial statements for 1972 through 1974 (App. B, *infra*, 19a). Federal securities laws require publicly-owned companies such as Amerada to file such certified financial statements annually. See 15 U.S.C. 78c and 17 C.F.R. Part 210 *et seq.* The certification process requires the independent auditor to evaluate the adequacy of the corporation's reserve for potential future tax liabilities. As part of its certification of Amerada's financial statements, respondent prepared tax accrual workpapers, which are documents and memoranda relating to respondent's evaluation of Amerada's tax liability reserves as they appeared in its financial statements. The tax accrual workpapers contain facts pertaining to Amerada's financial transactions based upon company records and respondent's interviews with company personnel and with third parties. The information in the tax accrual workpapers may identify specific items of questionable deductibility that Amerada claimed for the particular year. If the auditor determines that items are not deductible or could reasonably lead to additional tax liability upon examination by the Internal Revenue Service, it will recommend the establishment of additional contingency reserves (App. B, *infra*, 24a-25a).

In May 1975, the Internal Revenue Service began an audit to determine Amerada's corporate income tax liability for

1972 through 1974. Amerada is an integrated oil company incorporated in Delaware, and its reported gross revenues for the years under audit exceeded seven billion dollars. During the course of the audit, Amerada disclosed to the revenue agents that it had maintained a "special disbursement account," a fund from which political contributions, gifts to foreign government officials, and other illegal or questionable payments were disbursed, and that it had convened a special committee to investigate the company's practices with respect to such payments. Amerada turned over the final report of its special committee to the Internal Revenue Service. The report disclosed the deduction of some $7,830 in questionable payments during the years in question (App. A, *infra*, 2a-3a; App. B, *infra*, 19a). Upon receipt of this information, the Internal Revenue Service assigned Special Agent Kalemba of the Criminal Investigations Division to join the investigation. In furtherance of the joint investigation, the Special Agent issued an administrative summons, pursuant to 26 U.S.C. 7602, to respondent, seeking, *inter alia*, its tax accrual workpapers. Pursuant to 26 U.S.C. 7609, notice of the summons was sent to Amerada, which thereupon instructed respondent not to produce any of the documents called for by the summons (App. A, *infra*, 2a-3a; App. B, *infra*, 19a-20a).

On October 9, 1979, the government commenced this proceeding to enforce the summons in the United States District Court for the Southern District of New York. Pursuant to 26 U.S.C. 7609, Amerada intervened in the proceeding. Both Amerada and respondent filed answers to the petition opposing enforcement of the summons, objecting, *inter alia*, to the production of the tax accrual workpapers (App. A, *infra*, 3a; App. B, *infra*, 18a).

The district court enforced the summons and ordered production of the tax accrual workpapers. It found that the documents were relevant to the Internal Revenue Service's tax investigation of Amerada and rejected respondent's claim of an accountant-client privilege. The district court noted this Court had refused to recognize such a privilege in *Couch* v. *United States*, 409 U.S. 322, 335-336 (1973), and that the First Circuit adhered to that view, even where the client

claimed that it gave the information to the auditor under an expectation of privacy. See *United States* v. *Arthur Andersen & Co.*, 623 F.2d 725, 728 (1980). As the district court concluded, "While there may be an expectation of privacy insofar as the world at large is concerned, Amerada cannot reasonably have such an expectation [of privacy] with regard to the IRS which, the taxpayer knew, could call for all materials underlying the tax returns and payments" (App. A, *infra*, 9a).

2. A divided panel of the court of appeals reversed the district court's order with respect to the tax accrual workpapers (App. B, *infra*, 28a-32a).[2] The court agreed with the district court's finding that the tax accrual workpapers were relevant to the IRS audit of Amerada's tax liability (App. B, *infra*, 24a-27a). Despite the relevance of the material, the court refused to enforce the summons because of its belief that "these documents should remain confidential in order to protect the reliability of the independent audit process" (App. B, *infra*, 19a).

In support of its decision, the court of appeals expressed the view that the policies behind the disclosure requirements of the federal securities laws outweighed the policies in support of the Internal Revenue Service summons authority. As the court reasoned, these "countervailing policies" "require[d] * * * [it] to fashion protection for the work that independent auditors, retained by publicly owned companies to comply with the federal securities laws, put into prepara-

[2] The Internal Revenue Service's summons directed respondent to produce all files related to its client, Amerada Hess Corporation, for which respondent served as independent auditor (App. B, *infra*, 17a-18a, 20a n.4). The district court ordered the production of all items sought by the summons except respondent's audit program and the documents prepared by the special committee that investigated Amerada's questionable payments. The government did not appeal that portion of the district court's order, except with respect to the stated items. Accordingly, the only issues considered by the court of appeals were the production of audit workpapers and tax accrual workpapers (App. B, *infra*, 20a-21a). The court of appeals affirmed the district court's order with respect to the audit workpapers (App. B, *infra*, 21a-24a). They are accordingly no longer at issue (App. B, *infra*, 24a-32a). Hence, the only question before this Court involves the tax accrual workpapers.

tion of tax accrual workpapers" (App. B, *infra*, 28a). If the summons were enforceable, the court feared corporate management "might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602 (footnote omitted)" (App. A, *infra*, 30a). The court concluded that enforcement would therefore handicap investors, who must rely on independent auditors for financial information regarding publicly traded securities (App. B, *infra*, 31a).

In reaching its decision, the court drew support from the attorney's work-product doctrine of *Hickman* v. *Taylor*, 329 U.S. 495 (1947), and created an accountant's work-product privilege, requiring the Internal Revenue Service to make a heightened showing of need to justify production of such documents (App. B, *infra*, 31a). In the court's view, the Internal Revenue Service had not made the requisite showing because "[t]he corporation's own books and the audit workpapers furnish the IRS with all the raw data that it need[s] to calculate the taxpayer's tax liability" (App. B, *infra*, 31a).

The dissenting judge would have enforced the summons (App. B, *infra*, 33a-39a). He believed that Congress had legislated in favor of disclosure of all relevant documents not subject to traditional common law privileges, which do not include a privilege for either client communications to an accountant or an accountant's work-product. At all events, the dissent observed that "[i]f there is to be recognition of new privileges, we should leave that task to Congress" (App. B, *infra*, 35a). The dissent found nothing in the language or the legislative history of Section 7602 to indicate that Congress intended to exempt an accountant's work-product from Internal Revenue Service examination, or anything in *Hickman* v. *Taylor*, 329 U.S. 495 (1947), or the Federal Rules of Civil Procedure, that would permit a court to depart from the broad command of Section 7602 (App. B, *infra*, 36a-37a). As the dissent pointed out, there is no proper analogy between the attorney-client relationship and that of the public corporation and the independent public accountant. The attorney-client relationship is completely private and cloaked in confidence. On the other hand, an independ-

ent public accountant has public obligations to assure itself that contingent tax liabilities have been accurately reflected, and must decline to certify a statement if it is not satisfied that it is accurate (App. B, *infra*, 37a-38a).

The dissenting judge also rejected the majority's premise that corporations would be so anxious to minimize their tax payments that they would be willing to deceive their own accountants about debatable tax items and thereby violate their obligations under the securities laws. He doubted "that many corporations will be so anxious to avoid that result that they will conceal these debatable items from their accountants in violation of the securities laws" (App B, *infra*, 36a). But even on the assumption that the majority's speculation were accurate, the dissent concluded that the courts should not afford publicly held corporations "any shield behind which they can increase their chances of avoiding detection that they have not paid either the amount of taxes a court might rule was lawfully required or whatever adjustment might result from a post-audit settlement" (*ibid.*).

REASONS FOR GRANTING THE PETITION

1. In refusing to enforce an Internal Revenue Service summons directing a certified public accountant to produce tax accrual workpapers prepared in connection with its regular financial audits of a publicly held corporation and its certification of the corporation's financial statements, the decision below has created an accountant work-product privilege, under the rationale of an accountant-client privilege, that threatens to impede the Internal Revenue Service's tax investigations of public corporations. The case therefore stands in derogation of this Court's ruling in *Couch* v. *United States*, 409 U.S. 322, 335 (1973), that "no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases * * *."

Moreover, the decision conflicts with *United States* v. *El Paso Co.*, 682 F.2d 530 (5th Cir. 1982). There, the court enforced an Internal Revenue Service summons for the identical category of documents prepared by a public corporation's in-house accountants and revealed to its independent accountant as part of the process of establishing a reserve for contingent tax liabilities and certifying its financial statements. In so holding, the court relied upon this Court's ad-

monition in *Couch* that there is no federal accountant-client evidentiary privilege, and thereby rejected "[t]he logic of [the decision below that] implies that the taxpayer's revelation of tax accrual workpapers to an accountant should be considered a communication in confidence" (682 F.2d at 540–541).[3]

As the substantial *amici* participation in the court below by representatives of the accounting community demonstrates (App. B, *infra*, 16a-17a), the question presented is of major importance to the administration and enforcement of the revenue laws, and to the accounting and legal professions. The tax accrual workpapers at issue in this case record the auditor's determination of the adequacy of a public corporation's reserve for contingent tax liability under generally accepted accounting standards. Accordingly, they are concededly relevant to a legitimate tax investigation. While the Internal Revenue Service does not routinely seek these accountants' workpapers,[4] it does request them in the course of complex audits of large corporations with substantial tax liabilities. Hence, the question of the enforceability of summonses directing the production of such documents has already been the subject of appellate litigation[5] and is likely to recur with frequency. As matters now stand, these summonses are not enforceable in the Second Circuit, where the financial records of some of the nation's largest corporations are located. This Court should grant certiorari and establish a uniform national rule with respect to the production of such tax accrual workpapers.

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[3] We have been advised by counsel for El Paso Company that he intends to seek certiorari.

[4] See *Guidelines for Requesting Audit or Tax Accrual Workpapers*, [Audit] I Int. Rev. Man. (CCH) ¶ 4024.4 (May 14, 1981).

[5] See, *e.g.*, *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979) (enforcing IRS summons to produce internal audit documents); *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass.), appeal dismissed, 612 F.2d 569 (1st Cir. 1979), cert. denied, 449 U.S. 1021 (1980) (enforcing IRS summons to produce audit work programs, tax accrual workpapers, and tax planning and consulting papers held by independent auditor); *cf. United States* v. *Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977) (IRS summons for tax accrual papers not enforced on ground of lack of relevancy).

2. a. As the Court most recently reaffirmed in *Trammel* v. *United States*, 445 U.S. 40, 50 (1980), quoting *United States* v. *Bryan*, 339 U.S. 323, 331 (1950), any claim of privilege must overcome the settled principle that "'the public * * * has a right to every man's evidence.'" Accord: *Branzburg* v. *Hayes*, 408 U.S. 665, 688 (1972). "Whatever their origins, these exceptions to the demand for every man's evidence are not lightly created nor expansively construed, for they are in derogation of the search for truth." *United States* v. *Nixon*, 418 U.S. 683, 710 (1974). See also *Herbert* v. *Lando*, 441 U.S. 153, 175 (1979); *Blackmer* v. *United States*, 284 U.S. 421, 438 (1932); 8 J. Wigmore, *Evidence*, § 2192 (McNaughton rev. ed. 1961). Because testimonial privileges preclude the use of highly relevant evidence and therefore tend to be "an obstacle to the administration of justice" (*id.* § 2192, at 73; see *United States* v. *Nixon*, *supra*, 418 U.S. at 711-713), such privileges are tolerable only when they "are designed to protect weighty and legitimate competing interests" (*id.* at 709). See also *Elkins* v. *United States*, 364 U.S. 206, 234 (1960) (Frankfurter, J., dissenting).

b. These considerations are fully applicable to the summons authority of the Internal Revenue Service. Section 7602 of the 1954 Code, App. E, *infra*, 42a-43a, authorizes the Secretary "[t]o summon * * * any * * * person * * * to appear * * * and to produce such books, papers, records, or other data * * * as may be relevant or material" to ascertaining the correctness of any return. "The purpose of the statutes is not to accuse, but to inquire. Although such investigations unquestionably involve some invasion of privacy, they are essential to our self-reporting system, and the alternatives could well involve far less agreeable invasions of house, business, and records." *United States* v. *Bisceglia*, 420 U.S. 141, 146 (1975).

In determining the scope of this statutory obligation to "appear" and "give testimony to the Internal Revenue Service," this Court has frequently analogized the summons power to the common law duties attaching to the issuance of a testimonial summons. See *United States* v. *Bisceglia*,

supra, 420 U.S. at 147-148; *United States* v. *Powell*, 379 U.S. 48, 57 (1964). This common law duty has been expansively construed and limited principally by relevance and privilege. See, *e.g.*, *Blair* v. *United States*, 250 U.S. 273 (1919); *United States* v. *Bryan*, *supra*, 339 U.S. at 331. While the Court has recognized that there may be exemptions from the public duty to give evidence to a competent authority, the "primary assumption" was that a summoned party must "give what testimony one is capable of giving" absent an exemption "grounded in a substantial individual interest which has been found, through centuries of experience, to outweigh the public interest in the search for truth" (*ibid.*).

Moreover, the Court has consistently construed the breadth of the summons authority that Congress intended to confer in Section 7602 as embracing all appropriate measures for enforcement. See, *e.g.*, *United States* v. *Powell*, *supra*; *Donaldson* v. *United States*, 400 U.S. 517 (1971); *United States* v. *Bisceglia*, *supra*; *United States* v. *Euge*, 444 U.S. 707 (1980). "There is thus a formidable line of precedent construing congressional intent to uphold the claimed enforcement authority of the Service if authority is necessary for the effective enforcement of the revenue laws and is not undercut by contrary legislative purposes (footnote omitted)" (*id.* at 715-716). Simply put, an Internal Revenue Service summons to produce evidence relevant to a legitimate investigation is enforceable unless an established privilege protects such evidence or there are "unambiguous directions from Congress" to the contrary. *United States* v. *Bisceglia*, *supra*, 420 U.S. at 150.

3. Here, both courts below found that the tax accrual papers sought from respondent were relevant to the Internal Revenue Service's investigation of Amerada (App. A, *infra*, 8a; App. B, *infra*, 26a-27a). Despite this finding, the court of appeals refused to order production of these documents prepared by respondent in connection with its determination of the adequacy of Amerada's reserve for contingent tax liabilities and its certification of Amerada's financial statements, as required by the securities laws. As the court saw the matter, "[t]he verification procedure envisioned by the [Securi-

ties] Act requires, in turn, that management feel free to cooperate with their auditors, and to disclose to them confidential information, such as the questionable positions taken on tax returns * * *" (App. B, *infra*, 29a). Hence, the court concluded that the countervailing policies at issue in the case "* * * required[d] [it] to fashion protection for the work that independent auditors, retained by publicly owned companies to comply with the federal securities laws, put into preparation of tax accrual workpapers" (*id.* at 28a). In support of its decision, the court relied upon the attorney work-product doctrine established by this Court's decision in *Hickman* v. *Taylor*, 329 U.S. 495 (1947).

But the work-product doctrine has no bearing upon the enforceability of the IRS summons for accountant's workpapers at issue in this case. In *Hickman* v. *Taylor*, *supra*, the Court recognized a qualified privilege against pretrial discovery for certain materials prepared by an attorney "acting for his client in anticipation of litigation" (329 U.S. at 508). See *United States* v. *Nobles*, 422 U.S. 225, 236-240 (1975); *Upjohn Co.* v. *United States*, 449 U.S. 383, 397-399 (1981). Here, in marked contrast, the papers in question were prepared by accountants in the course of a regular audit of financial statements—and not in connection with litigation no matter how remotely contemplated. These two factors effectively distinguish *Hickman* and render the work-product doctrine irrelevant. *United States* v. *El Paso Co.*, *supra*, 682 F.2d at 542–543.[6] The court below therefore erroneously extended the work-product doctrine beyond its settled and appropriate bounds.

4. While the decision below is couched in terms of the work-product privilege, it is plain that the court's underlying reasoning rests upon the creation of an accountant-client privilege. For in refusing to enforce the summons for the accrual workpapers, the court believed that it was fostering

[6] Accord: *Coastal States Gas Corp.* v. *Department of Energy*, 617 F.2d 854, 864 (D.C. Cir. 1980) ("[work-product doctrine] has uniformly been held to be limited to documents prepared in contemplation of litigation"); *Goosman* v. *A. Duie Pyle, Inc.*, 320 F.2d 45, 52 (4th Cir. 1963) (reports prepared in ordinary course of business under Interstate Commerce Commission regulations are not work-product).

candid communications between client and accountant for the benefit of the investing public and the enforcement of the securities laws. Such a rationale is the essence of a communications privilege. See *United States* v. *El Paso Co.*, *supra*, 682 F.2d at 541 n. 13.

There are, we submit, four fundamental errors inherent in the court's conclusion. First, there is no accountant-client privilege, and the courts have uniformly resisted creating one because of the significant differences between attorneys and certified public accountants. Second, the court's conclusion that such a privilege is necessary in order to encourage enforcement of the securities laws is based upon an unfounded speculation that public companies would otherwise deceive their independent accountants. Third, there is no conflict between the enforcement of the securities laws and the tax laws. And fourth, even on the assumption that there is such a conflict, it is for Congress, and not the court below, to resolve it.

a. As we have pointed out (*supra*, page 6), this Court, and every court that has considered the issue, has rejected the creation of an accountant-client privilege. *Couch* v. *United States*, *supra*, 409 U.S. at 335-336; *Falsone* v. *United States*, 205 F.2d 734 (5th Cir.), cert. denied, 346 U.S. 864 (1953); *Wm. T. Thompson Co.* v. *General Nutrition Corp.*, 671 F.2d 100, 103-104 (3d Cir. 1982); *United States* v. *Gurtner*, 474 F.2d 297, 299 (9th Cir. 1973); *United States* v. *Wainwright*, 413 F.2d 796, 803 (10th Cir. 1969); *United States* v. *Kovel*, 296 F.2d 918, 922 (2d Cir. 1961); *United States* v. *El Paso Co.*, *supra*, 682 F.2d at 540. Indeed, the reason the law recognizes an attorney-client privilege and not an accountant-client privilege rests upon the important practical differences between the function of an accountant and that of an attorney. The attorney is an advocate whose duties to his client include presenting the client's case in the most favorable light possible. As this Court noted in *Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 390-391, "[t]he first step in the resolution of any legal problem is ascertaining the factual background and sifting through the facts with an eye to the legally relevant." Accordingly, unless a client's communications to his attorney are to be held

in strict confidence, the attorney may not be able to determine the correct facts, and, therefore not be able to represent his client's cause to the best of his ability.

An independent certified public accountant performs a very different function from that of an attorney. As the title states, he is independent of his client, and his responsibility is not only to the client whose books he is auditing but also to various governmental agencies regulating his client's industry, to his client's creditors and to investors in his client's securities. This multiplicity of loyalties, in contrast to the attorney's undivided loyalty to his client, exposes accountants to suits by agencies, creditors and investors on the theory that the accountant ignored his duty to them in favor of his loyalty to his client. In such suits, it is common for accountants to disclose their clients' confidential communications and their own work-product in order to demonstrate that they properly discharged their duties to all.[7] Indeed, it was precisely those differences between accountants and attorneys that this Court recognized in *Couch* in rejecting the claim of an accountant-client privilege as to a taxpayer's records turned over to an accountant. As the Court stated (409 U.S. at 335-336):

> [T]here can be little expectation of privacy where records are handed to an accountant, knowing that mandatory disclosure of much of the information therein is required in an income tax return. What information is not disclosed is largely in the accountant's discretion, not * * * [the taxpayer's]. Indeed, the accountant risks criminal prosecution if he willfully assists in the preparation of a false return. * * *. His own need for self-protection would often require the right to disclose the information given him. * * * Accordingly, * * * [taxpayer] cannot reasonably claim * * * an expectation of * * * privacy or confidentiality.

[7] See, *e.g.*, *Pegasus Fund, Inc.* v. *Laraneta*, 617 F.2d 1335 (9th Cir. 1980) (Arthur Young & Co. produced its work papers to show that it had no reason to know of fraud by its client); *Oleck* v. *Fischer*, 623 F.2d 791 (2d Cir. 1980) (Arthur Andersen & Co. testified regarding reserves for notes payable appearing in client's financial statement); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976); *SEC* v. *Geotek*, 426 F. Supp. 715 (N.D. Cal. 1976), aff'd, 590 F.2d 785 (9th Cir. 1979).

Thus, an accountant's client obviously cannot have an expectation of confidentiality similar to that of an attorney's client. There is accordingly no justification for the creation of an accountant-client privilege by the decision below.

b. Moreover, even on the assumption of the court below (with which we disagree) that there is some privilege that attaches to the communications between a client and his accountant that is somewhat analogous to the attorney-client privilege, the rationale for such a privilege does not exist in this case. the principal contemporary justification for the attorney-client privilege is its presumed value in encouraging clients to make full disclosure to their attorneys. *Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 389; 8 J. Wigmore, *supra*, §§ 2291 and 2306, at 590. If damaging information could more readily be obtained from an attorney following disclosure than from the client himself in the absence of disclosure, a client aware of that fact would be reluctant to confide in his lawyer. See, *e.g.*, *United States* v. *Louisville & N. R.R.*, 236 U.S. 318, 336 (1915). The result would be greater difficulty in obtaining fully informed legal advice. "Since the privilege has the effect of withholding relevant information from the factfinder, it applies only where necessary to achieve its purpose. Accordingly it protects only those disclosures—necessary to obtain legal advice—which might not have been made absent the privilege." *Fisher* v. *United States*, 425 U.S. 391, 403 (1976).

But the communications from Amerada to respondent in this case would undeniably have been made in the absence of any protection of an accountant-client privilege. As a publicly held corporation, Amerada was required to file accurate and complete financial statements, certified by its independent auditors, with the SEC, if it wished to continue to have its stock publicly traded. See 15 U.S.C. 78*l*; 17 C.F.R. 210.1-02(d). Thus, Amerada had an independent legal duty to make the disclosures to respondent wholly without reference to or encouragement by any privilege. As the dissenting judge pointed out, there is accordingly no justification for the majority's premise "that some corporations are so anxious to minimize their tax payments that they are willing to deceive their accountants concerning the existence of

debatable items and thereby violate their obligations under the securities laws" (App. B, *infra*, 36a; (footnotes omitted)). Indeed, the cost of financial deceit is high for it can cut the corporation off from the public capital markets and expose it to private causes of action. It is therefore the accountant's public duty to withhold certification of a false, incomplete or misleading statement, and it is the sanctions of the securities laws—not the existence of any privilege—that provide the corporation with the necessary incentive to be candid with its independent auditor (see App. B, *infra*, 37a-38a). See also *In re John Doe Corp.*, 675 F.2d 482, 488-489 (2d Cir. 1982).

c. The court of appeals further erred in assuming a conflict between the federal statutes regulating securities and those enforcing revenue collection. Section 7602 of the 1954 Code unequivocally authorizes agents of the Internal Revenue Service to summon and inspect records that may be relevant to their investigation. On the other hand, the securities regulations relate to nothing more than the duty of listed corporations to file annual audited statements, and the duty of auditors to examine the statements under generally accepted principles of public accounting. The statutes and regulations do not even hint at any duty by the accountants to keep their clients' communications confidential. It would therefore be incongruous to enjoin accountants to do so when their basic function is clearly to insure that the public is informed accurately.

As the Court made clear in *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), only a conflict that appears in the statutes themselves, as a clear statement of congressional purpose, will prevent disclosure of information. In *St. Regis Paper Co.*, Section 9(a) of the Census Act, 13 U.S.C. (1958 ed.) 9(a), prevented the Census Bureau from disclosing census information except in the form of statistical reports. St. Regis Paper Co. asserted that this prohibition was, in effect, a pledge of confidentiality and protected the company from having to disclose the same information to the Federal Trade Commission. This Court disagreed, holding that the statute merely forbade dissemination of the information by the Census Bureau; it said nothing to curtail the normal in-

vestigatory powers of other government agencies. The Court refused to infer such a limitation: "Ours is the duty to avoid a construction that would suppress otherwise competent evidence unless the statute, strictly construed, requires such a result." 368 U.S. at 218. The Court further pointed out (*ibid.*) that "when Congress has intended that like reports not be subject to compulsory process it has said so." The present case follows *a fortiori* from *St. Regis Paper Co.* since the securities laws and regulations do not contain any requirements of confidentiality for accountants. There is accordingly no justification for creating a privilege for such relevant materials as a defense to an otherwise valid Internal Revenue Service summons issued pursuant to a legitimate investigation.

d. Finally, even assuming that the court below correctly identified a conflict between the policies underlying the securities laws and the provisions regarding tax enforcement, the resolution of such a conflict properly lies with Congress and not in the courts. This is particularly true where, as here, the securities laws provide no explicit defense to the Internal Revenue Service's summons and a literal reading of the revenue provision directs that the documents be produced. There is no justification for the implicit assumption by the decision below that the securities law has somehow repealed or cut back on the scope of the Internal Revenue Service's summons authority. "One canon of construction is that repeals by implication are disfavored." *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 133 (1974). Since the IRS summons statutes and the securities laws are "'capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective.'" *Id.* at 133-134, quoting *Morton* v. *Mancari*, 417 U.S. 535, 551 (1974). As the Fifth Circuit put it in *El Paso Co.* in reaching the opposite conclusion from that of the court below (682 F.2d at 545): "In the absence of a more profound clash between congressional policies, we cannot cut back on the summons power that Congress has given to the Service. We do not feel free to reweave the fabric of national legislation in accord with our notions of how various statutory schemes mesh. Such policy choices belong to the Congress."

CONCLUSION

The petition for a writ of certiorari should be granted.

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OCTOBER 1982

APPENDIX A

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT

AND

AMERADA HESS CORPORATION, INTERVENOR

No. M-18-304 (KT1).

United States District Court,
S. D. New York.

Aug. 26, 1980

OPINION

KEVIN THOMAS DUFFY, District Judge:

This matter comes before the court on an order to show cause why respondent, Arthur Young & Company [hereinafter referred to as "Young"], should not be compelled to obey an Internal Revenue Service [hereinafter referred to as "IRS"] summons directing it to testify and to produce for examination certain documents pertaining to the tax liabilities of intervenor Amerada Hess Corporation [hereinafter referred to as "Amerada"] for tax years 1972, 1973 and 1974. The summons was issued pursuant to Section 7602 of

the Internal Revenue Code, 26 U.S.C. § 7602,[1] et al requested the documents set out in the margin.[2] The underlying investigation was commenced in August 1977, after

[1] 26 U.S.C. § 7602 provides as follows:

Examination of books and witnesses

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

[2] The following documents relating to Amerada Hess Corporation all for the years 1972 through 1974:

1. Engagement letter(s)
2. Management letter(s)
3. Representation letter(s)
4. History file(s)
5. Standard workpaper index(s)
6. Administrative file(s)
7. Workpaper review file(s)
8. Engagement planning file(s)
9. Confirmation control file(s)
10. Significant event file(s)
11. Audit program file(s)
12. Audit workpaper's file(s)
13. Tax pool analysis file(s)
14. File(s) prepared during the course of work performed for the "special committee", including agreed procedures, selection process reports, schedules and other workpapers
15. The name of the partner in charge, engagement partner and/or senior auditor who directed the audit of Amerada Hess Corporation
16. Any other information pertinent to the audit of Amerada Hess Corporation covering the years 1972, 1973, and 1974

Amerada made certain disclosures to the IRS concerning the deduction of some $7,830 in questionable payments during the years in question.

On January 12, 1978, two IRS summonses ["the New Jersey summonses"] were served on Amerada at its New Jersey offices. Amerada notified the IRS that it would not comply with these summonses, whereupon the IRS filed an enforcement petition on April 26, 1978, in the United States District Court for the District of New Jersey.

After an evidentiary hearing, the late Judge Barlow entered an order on January 22, 1979, granting the petition to enforce. *United States* v. *Amerada Hess Corp.*, No. 78-753 (D.N.J.1978) ("Hess I"). The Third Circuit affirmed, 619 F.2d 980 (1980). Although the documents sought, and now turned over, pursuant to the New Jersey summonses are not the same as those sought in the present action, some of the issues litigated and resolved there are germane to these proceedings, as will be discussed below.

The summons in question here was served on Young by Special Agent Kenneth Kalemba of the IRS on April 17, 1978. Notice of this summons was sent to the taxpayer Amerada by certified mail on April 18, 1978. On April 21, 1978, the taxpayer, utilizing the provisions of 26 U.S.C. § 7609(a), directed Young, its outside auditor, not to comply with the summons.

The instant enforcement petition was filed by the IRS in this court on October 15, 1979 under 26 U.S.C. §§ 7402(b) and 7604(a). Respondent Young opposes the summons in its own right, as a matter of its own policy judgments, and not only because it has been directed by its client Amerada not to comply. Young advances five arguments against compliance. Amerada has also intervened and advances arguments of its own against compliancy.

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17. All workpapers, reports, records, correspondence, reconciliations and information relative to the United States Corporate Income Tax Returns (Forms 1120) of Amerada Hess Corporation that were prepared by Arthur Young & Company or under the supervision of Arthur Young & Company for the calendar years 1972, 1973 and 1974

Young's Arguments

Young puts forth what it characterizes as basic policy arguments as to why it should not be ordered to comply with the IRS summons. The first of these arguments is that the summons requests virtually every piece of paper in Young's files concerning Amerada, totalling approximately a quarter of a million pages, and that such an overbroad, generic request violates the second of the four requirements of *United States* v. *Powell*, 379 U.S. 48, 57-58, 85 S.Ct. 248, 254-255, 13 L.Ed.2d 112 (1964). Under *Powell*, the four essential criteria for the judicial enforcement of an IRS summons are:

> that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed
>
> . . . .
>
> 379 U.S. at 57-58, 85 S.Ct. at 255.

According to Young, a request such as the one at hand is so broad that it negates the court's oversight function and effectively makes the IRS summons self-enforcing, contrary to the intent of Congress as set out in 26 U.S.C. § 7604.

The IRS responds that it has, through the affidavits of its agents, made an initial showing that the four *Powell* requirements have been satisfied,[3] and that the burden is therefore on respondent to show that enforcement would be an abuse of the court's process. The IRS argues that this burden has not been met. It also argues that generic and extensive document requests have repeatedly been upheld by the courts.

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[3] The court has been furnished with affidavits covering each of the four *Powell* requirements, *supra*, for judicial enforcement of an IRS summons. The four grounds are covered respectively by the affidavits of (1) Special Agent Kenneth J. Kalemba, and the Supplemental Affidavit of Special Agent G. Robert Armstrong; (2) District Director Harry Reiter, of the IRS New York District; (3) Revenue Agent Anthony Caputo of the IRS Newark District; and (4) Kenneth J. Kalemba, *supra*.

The cases cited by the IRS support its position and Young's attempts to distinguish them are unconvincing. In *United States* v. *Acker*, 325 F.Supp. 857 (S.D.N.Y. 1971), Judge Frankel approved a similarly broad IRS summons and construed 26 U.S.C. § 7602 as authorizing IRS inspection of documents which "'might' throw light upon subjects under legitimate inquiry." 325 F.Supp. at 862. As Judge Frankel reasoned in *Acker*, the IRS agents cannot and need not establish "probable cause" to justify their document demands. What they must do, and have done in the case at hand, is to show that the documents are sought in pursuit of a legitimate purpose and may be relevant to that purpose. *See United States* v. *Powell*, *supra*, 379 U.S. at 57, 85 S.Ct. at 254.

The end result of respondent's argument about generic document demands would be that a reviewing court must test each individual piece of paper for relevance and this cannot be.[4]

> The materials demanded must be "sufficiently relevant to the investigation," *United States* v. *Harrington*, 388 F.2d 520, 523 (2d Cir. 1968), a standard to be applied to categories of documents, not to every single document within any category. So, for example, to look no further than the case just cited, it may be confidently supposed that not all of the books and records there required to be produced (by the third party, not the taxpayer himself) would prove "relevant or material" to the subject being explored. But it was enough even where the burden was upon the third party there involved that there was "in the particular circumstances an indication of a realistic expectation rather than an idle hope that something [might] be discovered."

[4] "If what appellant desires is to have the district judge examine the materials *in camera* so as to increase his understanding of their relevancy and materiality to the tax investigation, this would be a task which, in most cases, certainly including this one, would be so burdensome and probably so impossible of performance that Congress could not have meant to impose it upon busy district judges.

United States v. *Noall*, 587 F.2d 123, 127 (2d Cir. 1978).

United States v. *Acker*, 325 F.Supp. at 862.[5]

Young attempts to distinguish the other cases relied on by the IRS on the grounds that the broad document requests approved in those cases were limited to records of actual transactions between the taxpayer and the third party. In most of the cases, however, the third party was a bank and the requests were only for records of transactions between the taxpayer and the bank. *United States* v. *Coopers & Lybrand*, 413 F.Supp. 942 (D.Colo.1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), is the one case that did not involve an independent auditor, and made a distinction between transactional and other kinds of records. That case, however, is of no support to Young's attack on the breadth of the summons, for it denied enforcement of the summons only as to the audit program and tax pool analysis file. These issues will be discussed below.

Young's first argument must fail in that the present summons cannot be resisted simply on the grounds that it is overbroad.

Young next argues that its tax accrual files should, as a matter of law and policy, be protected from disclosure to the IRS. Tax accrual files, or the tax pool analysis papers, are the auditor's evaluation of the adequacy of the taxpayer-client's provision for taxes on the client's financial statements. They contain projections, opinions and hypotheses of possible tax consequences based on factual data derived from the client's records. Young argues that disclosure of such files to the IRS would seriously undermine the ability of the client to deal candidly with its auditor. It also argues that since they consist primarily of opinion, such files are not relevant to determining the client's tax liabili-

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[5] In a footnote to the quoted passage from *Acker*, Judge Frankel acknowledges that the Second Circuit in *Harrington* stressed that judicial protection is even more appropriate when sweeping demands are directed not to the taxpayer, but to a third party, as is the case with the present summons. However, fears of oppressing or harassing Young are muted here, since the IRS has agreed to inspect all the subpoenaed documents on site in Young's New York City and Tulsa, Oklahoma offices, and to pay for the costs of any documents it wishes to reproduce.

ty. Finally, Young seeks to assert an indirect auditor-client privilege by arguing that the client enjoys an expectation of privacy for communications to its auditor.

Although case law on this precise question is spare and in apparent conflict, enough of a pattern has emerged to support the view that the tax accrual workpapers should be turned over.

In *United States* v. *Coopers & Lybrand*, 413 F.Supp. 942 (D.Colo.1975), the District Court held the IRS had failed to establish the relevance of the audit program (discussed below) and of the tax accrual files of Johns-Manville's outside auditor. Accordingly, the court refused to order and enforcement of the summons. The Tenth Circuit affirmed, 550 F.2d 615 (10th Cir. 1977), relying on the undisputed facts that the files in question were not used in connection with the preparation and filing of the taxpayer's returns and that the auditor had no responsibility for any of the client's tax matters. That is not quite the situation which obtains in the case at bar.

The opposite result was reached in *United States* v. *Arthur Anderson & Co.*, 474 F. Supp. 322 (D.Mass.) *dismissed without opinion*, 612 F.2d 569 (1st Cir. 1979) (Table), where the court was not persuaded by Andersen's accountant-client privilege argument or by its relevance argument. Rejecting the reasoning of *Coopers & Lybrand*, *supra*, the District Court in *Andersen* relied on the language of § 7602 to conclude that the audit program and the tax accrual papers were "both relevant and reachable," in that the statute's "expansive language invites, and has generally been accorded, a liberal construction." 474 F.Supp. at 329. The court specifically rejected the argument that the papers should be shielded from disclosure because they were not used in preparing the tax returns under investigation.

The respondent and intervenor in *Arthur Andersen*, *supra*, failed to obtain a stay of the enforcement order from the District Court, the First Circuit, or the Circuit Justice, and accordingly turned over the documents requested in the summons. Their appeal from that part of the order below was consequently dismissed as moot.

Any doubt as to which of these conflicting precedents should be followed in this instance is laid to rest by *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978) *cert. denied*, 441 U.S. 923, 99 S.Ct. 2031, 60 L.Ed.2d 396 (1979). *Noall* is not directly in point because the IRS summons in that case sought internal audit documents, and not the records of an independent auditor. However, the force and reasoning of *Noall* lead all but inescapably to the conclusion that the result in this Circuit would not be changed by this difference. Indeed, even though the Court of Appeals specifically reserved comment on the exact question presented here, *see* 587 F.2d at 127 n.5, the court left no doubt that it rejected the Tenth Circuit's reasoning in *Coopers & Lybrand*, *supra*:

> In refusing to enforce the summons in regard to the tax pool analysis, both the district court and the court of appeals gave much weight to the fact that this was not used in preparing the company's income tax return, 413 F.Supp. at 950, 953-54, 550 F.2d at 620-21. To the extent that the decision was influenced by this factor, it is not authoritative in this circuit.

587 F.2d at 127 (footnotes omitted).

Furthermore, *Noall* has been applied by a court outside this Circuit to order the disclosure of an independent auditor's "bluebacks," or audit reports on the taxpayer's internal accounting systems which were prepared by an independent auditor. *See United States* v. *The Riley Company*, 79 C. 4211 (N.D.Ill., January 8, 1980).

The IRS has made by affidavit, the showing of relevance required by *Powell*, *supra*. *See* Reiter Affidavit, ¶ 10; *United States* v. *Noall*, *supra*, 587 F.2d at 126; *United States* v. *Arthur Andersen*, *supra*, 474 F.Supp. at 329-30. Respondent's arguments that the tax accrual files are irrelevant and that their disclosure would undermine the auditor's function, are neither convincing nor supported by the weight of authority. *See Noall*, *supra*, 587 F.2d at 126. Respondent's argument based upon a supposed analogy to Exemption 5 in the Freedom of Information Act (dealing with internal government memoranda) is so wide of the mark that it does not merit discussion.

Nor can respondent be heard to assert an auditor-client privilege. The Supreme Court has refused to recognize such a privilege, *Couch* v. *United States*, 409 U.S. 322, 93 S.Ct. 611, 34 L.Ed.2d 548 (1973) and the First Circuit has very recently adhered to that view even where, as is the case here, the client claims that the information was given to the auditor under an expectation of privacy. *United States* v. *Arthur Andersen*, 623 F.2d 725, at 728 (1st Cir. 1980) (affirming District Court's enforcement of that part of the summons pertaining to Andersen's testimony about the tax accrual papers). While there may be an expectation of privacy insofar as the world at large is concerned, Amerada cannot reasonably have such an expectation with regard to the IRS which, the taxpayer knew, could call for all materials underlying the tax returns and payments.

Accordingly, I hold that respondent Young must make available for inspection by the IRS the tax accrual workpapers for Amerada covering the years in question.

Young makes basically the same arguments concerning its audit program workpapers for Amerada. These papers are the statement of the independent auditor's plan and program for the conduct of the audit. They are the auditor's methodology, the guidelines as to which areas and which records of the client will and will not be examined. Young argues that the audit program is confidential information which, if revealed to the client, might permit it to circumvent the audit, thereby defeating its very purpose.

Respondent's position on the audit program is sound. By definition, those papers are clearly less relevant to Amerada's tax liability than the tax accrual papers which, even though they consist in part of projection and hypotheses, also deal with facts and figures that form the basis of Amerada's tax liability, which the IRS desires to verify. The audit program, in contrast, stands many steps removed from the question of the actual tax liability.

Not only is the relevance of the audit program weaker, but the reasons for not disclosing it are stronger. The Second Circuit noted this in *Noall*, *supra*, 587 F.2d at 126 n.3, referring to the District and Circuit Courts' opin-

ions in *Coopers & Lybrand*, *supra*. The audit papers may be convenient for the IRS as a guide in its research, but convenience is not the touchstone here. The audit papers do not contain relevant data from which the IRS can assess the correctness of Amerada's tax returns. Accordingly, I must agree with what is explicit in both *Coopers & Lybrands* opinions, *supra*, and with what seems implicit in *Noall*, *supra*, and deny enforcement of that part of the instant summons, namely items 11 and 12, which seek production of Young's audit program and workpapers.

Young next argues that the 29 binders known as the Special Report Workpapers fall within the scope of the work product doctrine and therefore are protected from disclosure under *Hickman* v. *Taylor*, 329 U.S. 495, 67 S.Ct. 385, 91 L.Ed. 451 (1947). Young claims that it prepared these papers under a retainer from Amerada to assist Amerada's outside counsel, Milbank Tweed, in conducting an investigation into whether the corporation had made any improper foreign payments or political contributions.

The dispositive question on this claim is whether the papers in question were prepared in anticipation of litigation. *In re Grand Jury Subpoena*, 599 F.2d 504 (2d Cir. 1979). Judge Barlow in *Hess I* was faced with an issue tangentially related to the instant question. There, the IRS sought the names of all persons interviewed by Young in connection with the compilation of those 29 binders. A claim of privilege was raised by the taxpayer and in sustaining that claim, Judge Barlow held that the binders had been accumulated in contemplation of litigation.

Young argues that the IRS is bound by Judge Barlow's determination that the Special Report was prepared to assist counsel in anticipation of litigation and therefore protected from disclosure.

The IRS argues that the work-product doctrine does not apply in a summons enforcement proceeding, since the IRS is not bound by the rules of evidence applicable in judicial proceedings, but rather has a broad mandate from Congress to verify taxpayers' returns. The IRS argues that its investigative powers are not limited by, *inter alia*, the work-product doctrine. The Service further argues that

even if the doctrine is held to be applicable, as some courts have found, that the privilege is not absolute but may be, and in this case has been, overcome by the IRS's showing that it has "substantial need" for the materials in question and that the information cannot be obtained from any other source without undue hardship.

I agree with Judge Barlow's reasoning in *Hess I*, *supra*, that a party should not be completely barred from asserting the work-product privilege in the context of an IRS summons, but that in light of the unique inquisitorial mandate of the IRS, its burden of demonstrating "substantial need" to overcome the privilege should be reduced.

In passing upon the elements of the asserted privilege, I start from Judge Barlow's determination that the Special Committee was formed in anticipation of litigation.

I agree with respondent Young that the IRS has not met even a lowered burden of demonstrating both a substantial need for the Special Committee workpapers, and that the information contained therein cannot be obtained elsewhere without undue hardship. The IRS seems to rest on conclusory assertions of both need and hardship and can buttress its claims only with the statement that it has had to seek judicial enforcement of every subpoena it has addressed to Amerada or to any of its third party record keepers. Merely to say that a taxpayer has asserted its rights is no showing of "undue hardship" on IRS. As a citizen, I am somewhat appalled at the attitude which would produce such an argument.

The IRS may have a lower burden to overcome a claim of work-product privilege, but it still has some burden. The Reiter affidavit, which attempts to state the relevance of the subpoenaed documents of the IRS investigation, makes specific reference to several of the itemized requests in the summons, but refers to the Special Committee papers, item number 14 only as follows:

> The remaining items, numbered 14 through 17, pertain to specific factors involved in the investigation. (Reiter Affidavit, ¶3).

Furthermore, Young claims (Oresman Affidavit, ¶¶ 54–55) that the IRS has been furnished with the factual

data relating to the alleged questionable payments which were the focus of the Special Committee investigation. Also, the names of the persons interviewed by the Committee have been ordered turned over in *Hess I*, *supra*. These submissions indicate how far the IRS is from overcoming the asserted work-product privilege. Accordingly, I find that the 29 binders prepared by Young for Milbank Tweed's investigation need not be turned over to the IRS.

Young's final argument is moot, in that the IRS has agreed to inspect all documents on site in either Tulsa, Oklahoma, or New York City, and has further agreed to bear the costs of reproducing any documents it wishes to retain.

Amerada's Arguments

Intervenor-taxpayer Amerada has also advanced several arguments of its own against compliance. On one of these arguments, nothing more need be said since I have already held that the Special Committee Workpapers need not be turned over.

Amerada also argues that Young's tax accrual file should not be turned over. The only new argument it advances on this point is that such files do not consist of "books, papers, records, or other data" under 26 U.S.C. § 7602. By Amerada's own admission, no precise definition of such documents is provided by either the Internal Revenue Code or the legislative history of § 7602. Amerada's suggested statutory construction of that section amounts to no more than the argument that Congress must have intended such documents to be limited to records of actual transactions, and exclusive of judgmental or evaluative material. This argument has already been addressed, *supra*. The IRS has a wide latitude in fulfilling its mandate to police our basically self-reporting tax system, and a restrictive interpretation of the type of documents reachable under § 7602 would inhibit or defeat this mission. *See, e.g.*, *United States* v. *Bisceglia*, 420 U.S. 141, 145-46, 95 S.Ct. 915, 43 L.Ed.2d 88.

Amerada's final argument[6] is also without merit. It argues that the IRS has waived its right to seek enforcement by not insisting that Young appear on the return date of the summons, and because it did not institute this enforcement proceeding for several months after issuance of the summons.

There was no waiver by the IRS by reason of the lapse of time between issuance and institution of these proceedings. During this time, the Service was prosecuting other enforcement proceedings against Amerada and otherwise continuing the investigation.

Amerada, however, cites two cases in which the IRS was deemed to have waived enforcement by virtue of an agreement that respondent need not appear on the designated day. In *United States* v. *Malnik*, 489 F.2d 682 (5th Cir.), *cert. denied*, 419 U.S. 826, 95 S.Ct. 44, 42 L.Ed.2d 50 (1974), the IRS and the taxpayer's attorney agreed that instead of appearing to assert his Fifth Amendment privilege, the taxpayer would submit a written statement to the effect that, had he appeared, he would have asserted his appropriate constitutional privileges. The Fifth Circuit held that Malnik should have been required to appear and assert sert his constitutional claims to specific questions. However, the court went on to hold that the IRS had waived its right to seek enforcement because of its "indiscriminate agreement that Malnik need not comply with the demand of the summons" 489 F.2d at 688.

In *United States* v. *Lipshy*, 79-2 U.S.T.C. 88,274 (N.D. Texas 1979), the District Court found a similar waiver by the IRS, relying on *Malnik*, *supra*. The court found that even though the IRS did not evidence any subjective intention of abandoning enforcement of the summons, its agreement to dispense with the essential step in the examination process, i.e., the meeting at a time and place certain, acted as a waiver. The court refused to accept the Service's

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[6] By letter dated January 23, 1980, counsel for Amerada has withdrawn the defense that the summons was not issued in good faith, in light of the Third Circuit's affirmation of Judge Barlow in *Hess I*, 619 F.2d 980 (1980).

characterization of this agreement as merely a courtesy to avoid the necessity of the respondent's making a lengthy trip merely to announce that he would not comply.

These cases do not carry the day for Amerada for several reasons. *Malnik* involved the assertion of the Fifth Amendment privilege which, as the Fifth Circuit pointed out, could not be asserted in a blanket statement but must be raised only to specific questions and demands which would then be subject to court review. No such issue is involved here.[7] Second, in the present case, the only evidence offered of any "agreement" by the IRS is contained in ¶ 11 of the Affidavit of Carl D. Liggio, Arthur Young's General Counsel:

> 11. Following this conversation with Mr. Kalemba, I reiterated this in a telephone conversation on Thursday, April 20, 1978 and further confirmed it in a letter to him on April 25, 1978, a copy of which is attached as Exhibit A to this Affidavit. In that letter I stated:
>
> > As we further discussed when I met with you on April 17, I will be out of the area May 4, 1978, and thus unable to appear at the return date as established. *You indicated that because of our position with respect to the production, there was no need to appear and that the date was selected only to start the statutory period running.* (emphasis added).

The italicized portion could be read as an acceptance of an adjournment as much as an agreement to dispense with a meeting. In any event, it does not amount to an explicit "agreement" between the taxpayer and the IRS comparable to those in the cited cases.

Additionally, the IRS has changed its position on the "time and place certain" of the Amerada summons, and has agreed to examine the documents on site, as Amerada requested. Furthermore, in both *Malnik* and *Lipshy*, the IRS agreed to accept, in lieu of appearance, a written statement of respondent's objections. In the present case,

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[7] Because the Circuit Court in Malnik affirmed the District Court's refusal to enforce the summons, but did so on a wholly different ground, the IRS was not precluded from issuing another subpoena pertaining to the same material. 489 F.2d at 688 n.6.

no such agreement was reached. Indeed, Amerada instructed Young on April 21, 1978, not to comply with the summons, which was returnable on May 4. *See* Exhibit C to Enforcement Petition. No further formalism was required. The IRS, having no enforcement powers of its own, could hardly insist on compliance.

For all these reasons I find no waiver in the actions of the IRS following its issuance of the summons.

Accordingly, respondent Young is hereby directed to comply with the IRS summons of April 17, 1978 directing it to make available the requested documents pertaining to Amerada Hess, with the exception of the audit program (items 11 and 12), which is not relevant, and the Special Committee Report (item 14) which is protected under the work-product doctrine. All other items are to be made available for inspection by agents of the IRS at the Tulsa, Oklahoma or New York City offices of respondent. The IRS is to bear its own costs of reproducing whatever documents it deems necessary to copy.

SO ORDERED.

APPENDIX B

UNITED STATES OF AMERICA, PETITIONER-APPELLEE,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT-APPELLANT,

AND

AMERADA HESS CORPORATION,
INTERVENOR-RESPONDENT-APPELLANT.

Nos. 15, 16, Dockets 81-6048, 81-6056.

United States Court of Appeals,
Second Circuit.

Argued Oct. 26, 1981.

Decided April 13, 1982.

Before FEINBERG, Chief Judge and MANSFIELD and NEWMAN, Circuit Judges.

FIENBERG, Chief Judge:

This is an appeal from an order of the United States District Court for the Southern District of New York, Kevin T. Duffy, J., enforcing an Internal Revenue Service (IRS) summons to Arthur Young & Co. (AY). The summons, issued pursuant to 26 U.S.C. § 7602,[1] directed AY to

[1] 26 U.S.C. § 7602 provides in relevant part that:

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized—

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data,

produce all files related to its client, Amerada Hess Corp. (Amerada), for whom AY served as independent auditor. In response to an enforcement proceeding initiated by the IRS, Judge Duffy, in a decision reported at 496 F.Supp. 1152 (S.D.N.Y.1980), ordered the production of all the items requested by the IRS with two exceptions discussed below. The parties consented to a stay of production pending resolution of this appeal. In this court, AY challenges the district court's order, objecting primarily to the request for its audit workpapers file and for its tax pool (tax accrual workpapers) file. Amerada, utilizing the procedure available under 26 U.S.C. § 7609,[2] has intervened to challenge production of the tax accrual workpapers file. Because we

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and to give such testimony, under oath, as may be relevant or material to such inquiry: . . .

[2] 26 U.S.C. § 7609 provides in relevant part that:

(a) Notice—

(1) In general.—If—

(A) any summons described in subsection (c) is served on any person who is a third-party recordkeper, and

(B) the summons requires the production of any portion of records made or kept of the business transactions or affairs of any person (other than the person summoned) who is identified in the description of the records contained in the summons,

then notice of the summons shall be given to any person so identified within 3 days of the day on which such service is made . . . .

. . . .

(b) Right to intervene; right to stay compliance.—

(1) Intervention.—Notwithstanding any other law or rule of law, any person who is entitled to notice of a summons under subsection (a) shall have the right to intervene in any proceeding with respect to the enforcement of such summons under section 7604.

(2) Right to stay compliance.—Notwithstanding any other law or rule of law, any person who is entitled to notice of a summons under subsection (a) shall have the right to stay compliance with the summons if, not later than the 14th day after the day such notice is given in the manner provided in subsection (a)(2)—

(A) notice in writing is given to the person summoned not to comply with the summons, and

(B) a copy of such notice not to comply with the summons is mailed by registered or certified mail to such person and to such office as the Secretary may direct in the notice referred to in subsection (a)(1).

(c) Summons to which section applies.—

(1) In general.—Except as provided in paragraph (2), a summons is described in this subsection if it is issued under paragraph (2) of section 7602; . . .

find that the audit workpapers are relevant to determining Amerada's tax liability and thus fall within the scope of the IRS summons power, we affirm that part of Judge Duffy's order requiring their production. However, we reverse that part of the district court order enforcing the summons of the tax accrual workpapers. Although we find that this material is also relevant to the determination of tax liability, we believe that these documents should remain confidential in order to protect the reliability of the independent audit process.

I.

The involvement of Arthur Young & Co., a firm of certified public accountants, with Amerada Hess Corp. began in November 1971, when AY was retained as Amerada's independent auditor. Among its other duties, AY was responsible for reviewing the financial statements prepared by Amerada in satisfaction of the disclosure requirements of the federal securities law.[3] An AY partner also signed Amerada's tax returns, even though AY did not prepare the returns.

In April 1976, AY became further enmeshed in Amerada's affairs. Around that time, it became known that many American companies had made illegal payments abroad. In response to this publicity, Amerada's board of directors formed a special committee to investigate the possibility of Amerada wrongdoing. The law firm of Milbank, Tweed, Hadley & McCloy, and AY were engaged as independent investigators to assist the committee. This inquiry apparently, and despite the minor nature of the improprieties it uncovered, prompted the IRS in August 1977 to institute a criminal investigation of Amerada's tax returns for the years 1972, 1973, and 1974. Because a regular audit was then in progress, the IRS and Amerada designed a procedure in September 1977 to apprise the corporation of the progress of the criminal investigation. According to their agreement, Special Agent Kenneth Kalemba, who was in

[3] See § 12 of the Securities Exchange Act of 1934, 15 U.S.C. § 781, and Regulation S-X, 17 C.F.R. §§ 210 et seq. (1980).

charge of the criminal investigation, would issue all summonses relating to that inquiry. In April 1978, a summons signed by Kalemba was issued to AY, requiring it to make all its Amerada files available to the IRS.[4] A quarter of a million pages of documents are involved in this request.

The IRS sought to enforce this summons by an order to show cause, dated October 9, 1979. Judge Duffy tested the summons against the four criteria set forth in *United States* v. *Powell*, 379 U.S. 48, 57-58, 85 S.Ct. 248, 254-255, 13 L.Ed.2d 112 (1964):

> [The Commissioner] must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Com-

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[4] The summons requested the following documents relating to Amerada's tax liability for the years 1972–74:

1. Engagement letter(s)
2. Management letter(s)
3. Representation letter(s)
4. History file(s)
5. Standard workpaper index(s)
6. Administrative file(s)
7. Workpaper review file(s)
8. Engagement planning file(s)
9. Confirmation control file(s)
10. Significant events file(s)
11. Audit program file(s)
13. Audit workpaper's file(s)
13. Tax pool analysis file(s)
14. File(s) prepared during the course of work performed for the "special committee", including agreed procedures, selection process, reports, schedules and other workpapers.
15. The name of the partner in charge, engagement partner and/or senior auditor who directed the Amerada ...
16. Any other information pertinent to the audit of Amerada ... covering the years 1972, 1973 and 1974.
17. All workpapers, reports, records, correspondence, reconciliations and information relative to the United States Corporate Income Tax Returns (Forms 1120) of Amerada ... that were prepared by [AY] or under the supervision of [AY] for the calendar years 1972, 1973 and 1974.

At about the same time, a summons was issued to Amerada directly. Enforcement of this summons was also litigated, see *United States* v. *Amerada Hess Corp.*, 619 F.2d 980 (3d Cir. 1980), but none of the parties here contends that the different issues resolved there control the disposition of this appeal.

> missioner's possession, and that the administrative steps required by the Code have been followed. . . .

He found that with the exception of two types of documents, the summons satisfied all the prongs of the *Powell* test and, accordingly, enforced it. The exceptions related to AY's audit program and to the documents prepared by the special committee that investigated Amerada's questionable payments. Judge Duffy held that the audit program was irrelevant because it "stands many steps removed from the question of the actual tax liability." *United States* v. *Arthur Young & Co.*, 496 F.Supp. at 1157. He found that the committee report was protected by the work-product privilege under the doctrine of *Hickman* v. *Taylor*, 329 U.S. 495, 67 S.Ct. 385, 91 L.Ed.451 (1947), since the material was prepared under the auspices of Milbank, Tweed in anticipation of litigation, id. at 1157–58. The IRS does not appeal this portion of the district court's order. Among the documents that Judge Duffy did order turned over are AY's audit workpapers and tax accrual workpapers. The challenges advanced on appeal relate to these two categories.

II

AY alone objects to the production of its audit workpapers. These documents consist almost entirely of factual data generated from the books when accountants verify the financial statements prepared by Amerada's own personnel by spot-checking selected bookkeeping entries and records. They include third-party confirmations of transactions, as well as the auditor's own judgments about the implications of the company's transactions. Some of the workpapers contain material learned during confidential discussions between Amerada and AY employees. This material is not used in preparing Amerada's tax returns.

AY makes two objections to disclosure of these documents. First, it focuses on the second *Powell* criterion—relevance—and it claims that the IRS bears an enhanced burden of showing relevance when it seeks documents from a third-party, that is from an entity other than the taxpayer whose return it is auditing. Thus, AY at-

tempts to distinguished our holding in *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), cert. denied, 441 U.S. 923, 99 S.Ct. 2031, 60 L.Ed.2d 396 (1979), where a summons forcing a taxpayer to produce its own internal audit workpapers was enforced, on the ground that *Noall* did not involve a third-party. Where, as here, a stranger to the audit is involved, AY argues that this court's opinion in *United States* v. *Harrington*, 388 F.2d 520, 524 (2d Cir. 1968), controls and it is insufficient for the IRS merely to allege that some chance of relevance exists.

In *Harrington*, the target of the summons was a lawyer who had as his client the ex-wife of the taxpayer in whom the IRS was interested. In the course of enforcing the IRS summons, the court did point out that it was "particularly appropriate" that the lawyer and his client receive "judicial protection against ... sweeping or irrelevant order[s] ..." because the demand was "directed not to the taxpayer but to a third-party who may have had some dealing with the person under investigation." Id. at 523. But AY is not a stranger to Amerada's concerns in the same way that lawyer Harrington was to the husband taxpayer in *Harrington*. AY was hired to investigate Amerada's financial affairs, and to involve itself in matters that were likely to be the object of governmental inquiry. We do not believe that *Harrington* dictates the result sought by AY.

Moreover, we do not understand whose interests AY seeks to protect by this claim of an enhanced burden. Amerada does not need this protection: it can intervene in its own behalf under § 7609, see generally, Kenderine, The Internal Revenue Service Summons to Produce Documents: Powers, Procedures, and Taxpayer Defenses, 64 Minn.L.Rev. 73 (1979). And, in fact, it has done so. Since Amerada does not object to production of the audit workpapers, it would be anomalous to deny enforcement on the strength of its accountant's objection. Nor can AY assert any particular burden on it. Judge Duffy carefully protected AY from such possibilities by requiring the IRS to shoulder the costs and to inspect on site, *United States* v. *Arthur Young & Co.*, 496 F.Supp. at 1160.

Once it is accepted that the usual threshold of relevance applies, it is clear that the audit workpapers pass the *Powell* test. In *Noall*, we rejected a simplistic equation of relevance with use in tax return preparation, and recognized that

> the purposes of the internal audit include the detection of overstatements or understatements of revenues or expenses, and of identifying accounting procedures that would lead to these. If the internal auditors have ascertained an understatement of revenues or an overstatement of expenses, this plainly might throw light on the correctness of the returns.

587 F.2d at 126. AY has advanced no persuasive argument to distinguish between the usefulness of the internal audit procedure at issue in *Noall* and the external audit at issue here. The intervening decision in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 99 S.Ct. 773, 58 L.Ed.2d 785 (1979), does not change this result. There the Supreme Court held that the accounting methods that a taxpayer uses for his own financial records cannot be dispositive of the accounting method used for tax purposes. But that does not mean that the reliability of the taxpayer's records is not legitimately of interest to the IRS. Tax liability depends on a taxpayer's actual revenue and expenses, not on his bookkeeping. The IRS has an appropriate interest in ensuring that the latter accurately reflects the former.

AY next maintains that the broad, generic document request issued here cannot be tolerated under the Fourth Amendment. The federal courts have repeatedly dealt with similar contentions, and have consistently rejected them. Before the IRS knows where the issues lie, it has no choice but to utilize a general summons. Similarly, before the Service knows what the documents contain, it cannot describe them with any specificity. If the target's own opinion of relevance controlled, the entire audit process would be eviscerated. The judges in this circuit have therefore construed the summons power liberally, and allowed it to extend to widely-sweeping document requests. See, e.g., *United States* v. *Noall*, 587 F.2d at 127 (rejecting even in camera review as being overly cumbersome); *Foster* v.

United States, 265 F.2d 183, 186-187 (2d Cir.), cert. denied, 360 U.S. 912, 79 S.Ct. 1297, 3 L.Ed.2d 1261 (1959); *United States* v. *Acker*, 325 F.Supp. 857, 862-63 (S.D.N.Y. 1971) (Frankel, J.). AY argues that cases such as these do not apply here because it is a third party, not the taxpayer, but we have already rejected that premise on these facts. We therefore affirm that portion of the district court's order requiring AY to turn over the audit workpapers.

III.

AY is joined by Amerada and a host of amici curiae in challenging the power of the IRS to compel the disclosure of tax accrual workpapers. These documents are generated when an auditor verifies whether the taxpayer has accurately determined its contingent tax liability. Under the federal securities laws, a registrant must file a financial statement of its potential liabilities. Furthermore, the amici tell us that generally accepted auditing standards require an auditor to determine whether his client has put aside enough reserves to cover the contingency that, upon audit, it will owe the government more taxes than originally remitted. To make this assessment, the auditor must not only determine how the taxpayer treated his income and expenses in his tax return; he must also decide whether that treatment comports favorably with the Internal Revenue Code, the Regulations, and the case law. In areas where the law is unclear, he must predict the chances that the taxpayer's position will be upheld by the courts—a judgment based on his knowledge of the law and his opinion of where the law is headed. The auditor must also take into account the likelihood that the client will settle the dispute—a judgment based on the auditor's confidential and intimate knowledge of the client. This process frequently requires the auditor to elicit and engage in speculation as to positions that might be taken by the IRS and taxpayer, theoretical analysis, and opinions bearing on the fairness and reasonableness of the parties' positions (as distinguished from factual transactional data), which, if revealed to the IRS, could seriously prejudice the taxpayer in negotiations with it. If the auditor were required to disclose this

material, which is not used in preparation of the taxpayer's return and is not needed by the IRS to determine the correctness of the taxpayer's return, the auditor would probably be inhibited from creating or maintaining such papers as part of a full and frank exchange useful in complying with the taxpayer's obligations under federal securities laws.

The Service's emerging practice of requesting tax accrual workpapers[5] has aroused considerable controversy in the accounting and legal professions,[6] as well as sharp disagreement among the courts that have considered the issue.[7] In this appeal, appellants advance three arguments for denying enforcement to this facet of the summons. First, Amerada vehemently claims that since the summons was signed by Special Agent Kalemba, the relevance of the tax accrual workpapers must be measured with respect to the criminal investigation that Kalemba was conducting. In order words, Amerada claims that the September 1977 agreement restricts the IRS's right to obtain material to the task of the agent who summoned it.

The short answer to this argument is that Amerada has failed to prove the nature of its agreement with the IRS. We cannot place limits on the broad mandate that § 7602

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[5] The Service changed § 4024 of its Internal Revenue Manual in June 1979 to insert guidelines for requesting these workpapers. In June 1980, this section was further strengthened, see Caplin, Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers? 51 J.Tax. 194 (1979); Caplin, IRS Toughens its Stance on Summoning Accountant's Tax Accrual Workpapers, 53 J.Tax. 130 (1980); I.R.S. Eyes Accountants, 67 A.B.A.J. 1703 (1981). Amerada informs us, however, that in May 1981, the IRS issued new directives, backing down somewhat from its June 1980 position.

[6] In addition to the articles cited in note 5, supra, see, e.g., Kurtz, et al., Discussion on "Questionable Positions," 32 Tax Law, 13 (1978); Note, Government Access to Corporate Documents and Auditors' Workpapers: Shall we Include Auditors Among the Privileged Few? 2 J.Corp.L. 349 (1977).

[7] Compare *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322 (D.Mass.1979), appeal dismissed as moot, 623 F.2d 720 (1st Cir. 1980), cert. denied, 449 U.S. 1021, 101 S.Ct. 588, 66 L.Ed.2d 483 (1980), with *United States* v. *Coopers & Lybrand*, 413 F.Supp. 942 (D.Colo.1975), aff'd, 550 F.2d 615 (10th Cir. 1977).

gives the IRS with no more than taxpayer's contested assertion that the Service agreed to that limit. A longer answer is that § 7602 is only a power to compel production for the purpose of determining civil liability. Had an iron-clad agreement been forged to restrict the summons to documents pertaining to the criminal investigation, the summons would probably not have been enforceable, see *United States* v. *LaSalle National Bank*, 437 U.S. 298, 98 S.Ct. 2357, 57 L.Ed.2d 221 (1978). But as that case points out, the agent's personal motivation would not be dispositive in any case. In deciding enforcement issues, the court's mandate is to look at the motive of the "Service in an institutional sense . . . ." Id. at 319, 98 S.Ct. at 2368. Besides, considerations of judicial economy compel us to decide this question on broader grounds: If we denied enforcement only because the documents were irrelevant to Agent Kalemba's purpose, the IRS could simply issue a new summons, and the case would come before us again. Cf. *Hickman* v. *Taylor*, 329 U.S. at 505, 67 S.Ct. at 390 (declining to insist on "the empty formality of pursuing the right procedural device only to reestablish precisely the same basic problem now confronting us.").

This brings us to a more fundamental inquiry, namely, whether the summoned documents are relevant to the civil audit. Appellants derive considerable support for the proposition that this material is irrelevant from the Tenth Circuit's decision in *Coopers & Lybrand*, supra, and from *United States* v. *Matras*, 487 F.2d 1271 (1973), where the Eighth Circuit refused to enforce a § 7602 summons for taxpayer's proposed budgets. The reasoning in both cases can be summed up as follows: Tax liability depends on the taxpayer's actual transactions, not on what the taxpayer thinks and plans. Tax accrual workpapers reflect what the taxpayer—and his accountant—think about transactions that have already taken place; budgets reveal how the taxpayer hopes to conduct his affairs in the future. They are thus both irrelevant to the question of actual transactions, and therefore to the issue of liability for taxes. These courts conceded that both sorts of documents would be convenient to the IRS because they give the Service a "road

map" for following the management of the taxpayer's business. They went on to hold, however, that "[t]he term 'relevant' connotes and encompasses more than 'convenience.'" Id. at 1275. Consequently, they refused to require that the documents requested be turned over to the government.

We cannot agree with such a restrictive definition of relevance. The summons power has consistently been interpreted as a broad mandate, designed to give the Service the "authority ... necessary for the effective enforcement of the revenue laws ...." *United States* v. *Euge*, 444 U.S. 707, 715–16 & n.9, 100 S.Ct. 874, 880 & n.9, 63 L.Ed.2d 141 (1980) (enforcing a summons for an examplar of taxpayer's handwriting). See also *United States* v. *Powell*, supra (refusing to require a showing of probable cause in an enforcement proceeding); *Donaldson* v. *United States*, 400 U.S. 517, 91 S.Ct. 534, 27 L.Ed.2d 580 (1971) (refusing to deny enforcement of civil summons even though potential for criminal prosecution exists); *United States* v. *Bisceglia*, 420 U.S. 141, 95 S.Ct. 915, 43 L.Ed.2d 88 (1975) (upholding IRS power to issue a John Doe summons). Consequently, we have consistently used as our test of relevance whether the documents requested "might have thrown light upon" the correctness of a return, see, e.g., *United States* v. *Shlom*, 420 F.2d 263, 265 (2d Cir. 1969), cert. denied, 397 U.S. 1074, 90 S.Ct. 1521, 25 L.Ed.2d 809 (1970); *Foster v. United States*, 265 F.2d at 187; *United States* v. *Noall*, 587 F.2d at 125; *United States* v. *Acker*, 325 F.Supp. at 862. The documents at issue here certainly pass this low threshold of relevance. Different tax positions lead to different amounts of liability. It is difficult to say that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in his return would not throw "light upon" the correctness of the return.

Finally, the *Coopers & Lybrand* decision, upon which appellants have relied so heavily, emphasized the fact that the documents requested were not used in preparing the audited returns. This test has been rejected in this circuit, *Noall*, 587 F.2d at 126-27,[8] and accordingly, much of what was persuasive to the Tenth Circuit leaves us unimpressed.

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[8] It should be noted, however, that the decision in *Noall* specifically left open the issue now before us. 587 F.2d at 127 n.5.

The foregoing reasoning does not mean that the IRS summons in dispute here must now be mechanically enforced, for other considerations also bear on our decision. The Supreme Court has recognized that "contrary legislative purposes" can undercut the "broad latitude" otherwise provided to the IRS, *United States* v. *Euge*, 444 U.S. at 716 & n.9, 100 S.Ct. at 880 & n.9. It has also recognized that common law privileges serve to limit the scope of the IRS's power, *Upjohn* v. *United States*, 449 U.S. 383, 101 S.Ct. 677, 687, 66 L.Ed.2d 584 (1981); *United States* v. *Euge*, 444 U.S. at 714, 100 S.Ct. at 879. We think that the countervailing policies at issue in the case before us require us to fashion protection for the work that independent auditors, retained by publicly owned companies to comply with the federal securities laws, put into preparation of tax accrual workpapers.

Our starting point is *Hickman* v. *Taylor*, supra. In that case, the Supreme Court announced a policy of shielding "written statements, private memoranda and personal recollections prepared or formed by an adverse party's counsel in the course of his legal duties ..." 329 U.S. at 510, 67 S.Ct. at 393, not because the documents were "privileged or irrelevant," id. at 509, 67 S.Ct. at 392, but because their "[p]roper preparation ... is the historical and necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to protect their clients' interests." Id. at 511; 67 S.Ct. at 393. *Hickman* was decided in the context of discovery under the Federal Rules of Civil Procedure, and the doctrine enunciated there has since been incorporated into Fed.R.Civ.P. 26(b)(3). But neither the Court nor Congress expressed an intent to limit the doctrine to the discovery context, *Upjohn Co.* v. *United States*, 101 S.Ct. at 689. Rather, we read both *Hickman* and Rule 26 as requiring us to balance strong public policies against a party's need for information whenever a conflict between the two arises.

The conflict in this case is between "the legitimate interest of society in enforcement of its laws and collection of the revenues," *Couch* v. *United States*, 409 U.S. 322, 336, 93 S.Ct. 611, 619, 34 L.Ed.2d 548 (1973), and the "national

public interest [in] insur[ing] the maintenance of fair and honest markets in [securities] transactions," 15 U.S.C. § 78b. Congress has protected the former interest by vesting the Service with "the extensive powers granted ... by the Internal Revenue Code," *United States* v. *Powell*, 379 U.S. at 56, 85 S.Ct. at 254, including the summons power of § 7602. The latter interest has been vindicated by extensively regulating the securities industry. Foremost among these regulations is the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq., which requires public companies such as Amerada Hess to file financial statements, 15 U.S.C. § 78l, verified by independent accountants "in accordance with generally accepted auditing standards," 17 C.F.R. § 210.1-02(d). The verification procedure envisioned by the Act requires, in turn, that management feel free to cooperate with their auditors, and to disclose to them confidential information, such as the questionable positions taken on tax returns, and willingness to settle rather than litigate when these positions are challenged by the IRS. The procedure recognizes that since tax laws must be general enough to treat complex and diverse factual situations, they are necessarily drafted with a great deal of flexibility. The Code's requirements are therefore not always clear, and people of good faith can often take different positions as to the correct answer in a particular circumstance. While it is quite possible that a corporation motivated to save its shareholders' money might take a favorable—i.e. "minimum tax"—position on a debatable item, it is equally true that the Service, which is also composed of mortals, might, in its zeal to maximize revenues, take an equally incorrect "maximum tax" position. We do not agree with the dissent's statement that in the end, the corporation "pay[s] only what the tax laws required it to pay in the first place." This would be true if every difference of opinion were litigated. But the fact is that very few controversies reach that stage. In reality, at the end of an audit, the IRS and the taxpayers frequently compromise out their differences, each giving in a little. Such negotiations strike an appropriate balance between collecting revenue and conserving

judicial resources, but requiring the taxpayer alone to disclose settlement positions would improperly weight the balance.

The result of working with a tax code that is not cast in black and white is that the independent auditor is faced with a very sensitive inquiry. In order to assess whether the corporation has set aside enough reserves to pay contingent liabilities, the auditor must pinpoint possibly vulnerable areas in his client's tax return and then predict how the corporation will handle the Service and vice versa, if these areas are questioned on audit. The inquiry necessarily lays bare not only the auditor's thoughts but also the taxpayer's basic thinking, including decisions not to litigate that are based on considerations wholly apart from the inherent legality of what the taxpayer ..as done, e.g., the cost of the litigation and the possibility that confidential information may be disclosed to competitors. Divulging this information necessarily puts the taxpayer-corporation at a substantial disadvantage when it is audited. The prejudice involved in exposing to the Service appraisals of a taxpayer's weaknesses and settlement positions on audit is of such proportions that a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602.[9]

The case at bar therefore involves much more than delineating the scope of the IRS's authority under § 7602. When the IRS chooses to regularly summon tax accrual workpapers, it creates a clash between two important congressional policies. No matter how we decide this issue, one

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[9] The government contends that taxpayer's independent duty to comply with the SEC laws is assured by the risk of SEC prosecution, and exposure to civil suit. The full answer to this contention is provided in *Upjohn Co.* v. *United States*, 101 S.Ct. at 684 n.2:

> This response ignores the fact that the depth and quality of any investigations ... would suffer .... The response also provides too much, since it applies to all communications covered by the privilege: an individual trying to comply with the law or faced with a legal problem also has strong incentive to disclose information to his lawyer, yet the common law has recognized the value of the privilege in further facilitating communications.

policy has to bend a bit. Giving the complete latitude to the summons power that the IRS seeks here compromises the procedure designed by Congress to protect the investing public from inaccurate financial information. Protecting the accuracy of the securities laws dilutes the power of the Service to summon a roadmap of the thoughts and theories of a taxpayer and its independent auditor. However, so long as a case does not involve allegations of fraud, the Service does not need to know taxpayer's thoughts. The corporation's own books and the audit workpapers furnish the IRS with all the raw data that it need to calculate the taxpayer's tax liability. A roadmap would merely save the IRS some time in finding the best arguments for asserting the deficiency. The investing public, on the other hand, relies most exclusively on the data generated as a result of the SEC laws. It therefore seems to us that this collision requires that some form of privilege be carved out to protect the independent auditing process. A work-product privilege, similar to the privilege fashioned in *Hickman*, seems to us appropriate. It protects those who benefit from enforcement of the securities laws from the "grave dangers of inaccuracy and untrustworthiness," *Hickman*, 329 U.S. at 513, 67 S.Ct. at 394, that would result if tax accrual workpapers were routinely revealed to the Service. At the same time, it allows the IRS to procure these documents when the rare situation[10] arises where it can make a sufficient showing of need to adequately justify invading the integrity of the auditing process, cf. *Hickman*, 329 U.S. at 512-13, 67 S.Ct. at 394, Fed.R.Civ.P. 26(b)(3). In reaching this conclusion, we are comforted by the knowledge that if Congress feels that this privilege unduly restricts the IRS's authority, it can require that this material be made available, or that taxpayers flag their questionable positions directly on their returns, in line with the suggestions of former Commissioner Kurtz, 32 Tax Law. at 15-16; Cooper, The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics,

[10] See, e.g., Caplin, 51 J.Tax at 199 (corporate records destroyed by fire).

and Tax Reform, 80 Colum.L.Rev. 1553, 1612 (1980). Procuring tax accrual workpapers under § 7602 seems to us to effectuate Commissioner Kurtz's proposals through the back door.

In the case at hand, the IRS has not made a sufficient showing of need to override the privilege. Presumably, Amerada has made its own books available pursuant to the Third Circuit's decision in *United States* v. *Amerada Hess Corp.*, supra. In addition, this decision directs AY to release its audit workpapers, along with the other papers that the district court required it to turn over. Since the IRS is not attempting to prove that Amerada is guilty of fraud, the documents released should be sufficient for its purpose of determining the accuracy of Amerada's returns.

For the foregoing reasons, the judgment of the district court is affirmed in part and reversed in part.

NEWMAN, Circuit Judge, concurring in part and dissenting in part:

The Court today creates a form of accountant's work-product privilege to shield from scrutiny by the Internal Revenue Service an accountant's tax accrual work papers. These papers, reflecting the accountant's identification of doubtful items on the income tax return of the accountant's corporate client, would be examined by the I.R.S. pursuant to its summons authority, 26 U.S.C. § 7602 (1976), but for today's judicially-created exception. I respectfully dissent from this aspect of the Court's decision,[1] believing that Congress has legislated in favor of such examination, that if Congress has left the question open, the decision to create an accountant's work-product privilege should be made by Congress and not by a court, and that if the merits of such a privilege are to be weighed by a court, we should reject it.

1. In enacting § 7602, Congress has given the I.R.S. a broad summons authority to seek all information "relevant to a legitimate investigative purpose," *United States* v. *Bisceglia*, 420 U.S. 141, 146, 95 S.Ct. 915, 918, 43 L.Ed.2d 88 (1975). The majority agrees that Arthur Young's tax accrual work papers are relevant to the legitimate investigative purpose of determining the correctness of the tax returns of its client, Amerada Hess Corporation. In the absence of a preexisting privilege, such as the privilege against self-incrimination or the attorney-client privilege, this determination that § 7602 applies should result in enforcement of the summons. The majority does not purport

[1] I concur in those portions of Chief Judge Feinberg's opinion upholding enforcement of the summons for Arthur Young's audit work papers and determining that its tax accrual work papers are relevant to the I.R.S.'s civil audit of Amerada Hess Corporation.

to find anything in the text of legislative history of § 7602 to support an exception for an accountant's tax accrual work papers. I do not find anything in *Hickman* v. *Taylor*, 329 U.S. 495, 67 S.Ct. 385, 91 L.Ed. 451 (1947), or Rule 26 of the Federal Rules of Civil Procedure that requires or even permits this Court to depart from the broad command of § 7602.

The Supreme Court has observed that § 7602 is subject to the "'traditional privileges and limitations,'" *Upjohn Co.* v. *United States*, 449 U.S. 383, 398, 101 S.Ct. 677, 686, 66 L.Ed.2d 584 (1981), quoting *United States* v. *Euge*, 444 U.S. 707, 714, 100 S.Ct. 874, 879, 63 L.Ed.2d 141 (1980), which do not include a privilege for either client communications to an accountant, *e.g.*, *United States* v. *Wainwright*, 413 F.2d 796, 803 (10th Cir. 1969), *cert. denied*, 396 U.S. 1009, 90 S.Ct. 566, 24 L.Ed.2d 501 (1970); *United States* v. *Bouman*, 358 F.2d 421, 423 (3d Cir. 1966), or an accountant's work product, *e.g.*, *United States* v. *Kelly*, 311 F.Supp. 1216, 1217 (E.D.Pa.1969); *In re Rashba & Pokart*, 271 F.Supp. 946, 948 (S.D.N.Y.1967).[2] In *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923, 99 S.Ct. 2031, 60 L.Ed.2d 396 (1979), we were asked to create an exception for a corporation's own internal audit reports and related work papers on the ground that their disclosure to the I.R.S. would run counter to public policy by inhibiting frank disclosure from corporate employees to internal auditors. In rejecting that argument, we stated, "With respect to enforcement of tax laws, Congress itself has decided the policy issue, and it is

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[2] Federal law does not recognize accountant privileges even when the law of the forum state accords protection. *William T. Thompson Co.* v. *General Nutrition Corp.*, 671 F.2d 100 (3d Cir. 1982); *FDIC* v. *Mercantile National Bank of Chicago*, 84 F.R.D. 345, 349 (N.D.Ill.1979).

not for the courts to challenge that determination."[3] *Id.* at 126. I would accept Congress' judgment and enforce the summons fully.

2. If it were thought that the broad command of § 7602 leaves open the issue of whether to create an accountant's work-product privilege for tax accrual work papers, the decision to create such a privilege should be made by Congress. We have been authoritatively instructed not to place restrictions on the scope of § 7602 "absent unambiguous directions from Congress." *United States* v. *Bisceglia*, *supra*, 420 U.S. at 150, 95 S.Ct. at 920. I do not share the majority's comfort in knowing that if Congress prefers *not* to maintain an accountant's work-product privilege, it remains free to abolish it. That approach inverts the proper relationship between courts and Congress in this area. Congress has already legislated on the subject of the I.R.S.'s authority to examine relevant information, and it has thus far refrained from restricting the summons authority with any privileges unknown to the common law. If there is to be recognition of new privileges, we should leave that task to Congress. *Cf. City of Milwaukee* v. *Illinois*, 451 U.S. 304, 101 S.Ct. 1784, 68 L.Ed.2d 114 (1981) (presumption of preemption of federal courts' common law role as to subjects on which Congress has legislated). Especially is this the proper approach in matters concerning the tax laws, perhaps the one area of all national legislation in which Congress is most alert to remedy perceived inequities.[4]

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[3] I recognize that *Noall* explicitly left open the issue of whether § 7602 authorizes inspection of an accountant's tax accrual work papers, 587 F.2d at 127 n.5. However, several courts, including the District Court in this case, have found the rationale of *Noall* persuasive in upholding an I.R.S. summons for an accountant's tax accrual work papers. *United States* v. *Riley Co.*, 80-1 U.S. Tax Cas. (CCH) 9157 (N.D.Ill. Jan. 8, 1980); *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322, 330 (D.Mass.1979), *appeal dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021, 101 S.Ct. 588, 66 L.Ed.2d 483 (1980); *cf. In re Grand Jury Subpoenas Duces Tecum Involving Charles Rice*, 483 F.Supp. 1085, 1088 (D.Minn.1979).

[4] Congress, which annually amends the tax laws, sometimes as to details concerning a single taxpayer, has had notice that federal courts are enforcing I.R.S. summonses for accountant's tax accrual work pa-

3. If we were to enter the policy debate as to whether to create a privilege to protect an accountant's tax accrual work papers, the privilege should be rejected. The majority suggests the privilege is needed to ensure that public corporations will be truthful with their accounts in fulfilling their statutory obligations to file financial statements verified by independent accountants. *See* 15 U.S.C. § 78*l* (1976); 17 C.F.R. § 210.1-02(d) (1981). Analogy is drawn to the work-product privilege of attorneys. I am not persuaded by either the argument or the analogy.

The policy argument rests on an indictment of corporate America that I do not accept. The premise is that some corporations are so anxious to minimize their tax payments that they are willing to deceive their accountants concerning the existence of debatable tax items and thereby violate their obligations under the securities laws.[5] Doubtless all corporations are anxious to pay only the minimum taxes required, and, toward that end, many will take favorable positions on debatable items, some of which the I.R.S. will successfully challenge. But even when the I.R.S. prevails, the corporation ends up paying only what the tax laws required it to pay in the first place.[6] I doubt that many corporations will be so anxious to avoid that result that they will conceal these debatable items from their accountants in violation of the securities laws. But if a few are so tempted, courts should not afford them any shield behind which they can increase their chances of avoiding detection that they have not paid either the amount of taxes a court might rule was lawfully required or whatever adjustment might result from a post-audit settlement. In *Noall* we declined to give

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pers, at least since 1979 when *United States* v. *Arthur Andersen & Co.*, *supra*, was decided.

[5] To the extent that the majority is creating a privilege to encourage communication from the client to the accountant, it is creating a testimonial privilege for the corporation, not a work-product protection for the work of the accountant.

[6] I assume the majority's privilege will protect an accountant's analysis of potential liability only of a civil nature. An accountant's privilege, no more than the attorney-client or attorney work-product privileges, should surely not insulate on-going attempts by the corporation or its accountants to carry out criminal evasion of taxes.

corporations an opportunity to shield their own audit work papers from I.R.S. scrutiny, despite the argument that employees would be tempted to deceive internal auditors. I see no reason to be more solicitous of corporations when they elect to enter public capital markets where they are obliged to accept the requirements of complete and honest financial disclosure.

Moreover, the argument that corporate taxpayers will be reluctant to assist in creating records accurately reflecting their contingent tax liabilities proves too much. If that premise were followed, we should insulate from § 7602 all the taxpayer's records supporting his claimed tax liabilities, since their inspection by the I.R.S. frequently results in an upward adjustment of tax payments and the taxpayer therefore has an incentive not to maintain them. It is entirely speculative whether the statutory disclosure obligations of the securities laws present a greater need to create new privileges than do the record maintenance obligations of the tax laws themselves. *See, e.g.*, 26 U.S.C. § 7203 (1976).

Arguably, it is more important to protect the investing public with contingent-tax-liability disclosure obligations than to protect the public revenues with tax-record maintenance obligations and undiminished summons authority, but that is precisely the sort of policy choice to be made by Congress. A legislative hearing is a better forum than this appeal to determine how realistic is the threat that occasional instances of understated contingent tax liabilities that result in additional tax payments will prejudice investor decisions and whether such a threat justifies diminution of tax revenues by preventing the I.R.S. from focusing its limited auditing resources on identified questionable items.

Furthermore, it is far from clear that the absence of an accountant's work-product privilege increases the risk that a corporation would have much success even if it were tempted to default on its disclosure obligations in the area of contingent tax liabilities. The corporation's independent public accountant has public obligations to assure himself that contingent tax liabilities have been accurately reflected. If the corporation blocks the efforts of the accountant to

ascertain the true state of the company's contingent tax liabilities, the accountant would be obliged to decline to certify the financial statements.

This last consideration indicates why the work-product privilege of the attorney is not analogous. The attorney is retained by the client in a completely private relationship, frequently to protect his client against claims of the Government. The work-product privilege assures legitimate privacy to the activity of the attorney in discharging his obligations to the client in vindication of a constitutional right to effective counsel. If the client elects not to make full disclosure to his attorney, the attorney may still undertake the defense; though he may not knowingly abet perjury, he has no obligation to the public to elicit and disclose the true state of his client's affairs. The certified public accountant, however, especially when he certifies financial statements of public corporations, has responsibilities to the public that far transcend his private employment relationship. In preparing and certifying such statements, he is not retained to defend his client against the Government; he is retained to assist his client in complying with government obligations to inform the investing public.

Finally, it is worth noting that privileges generally are created to serve some policy, independent of lawful obligations, that it thought to be impaired in the absence of the privilege. The law does not require spouses to confide in each other, but it nonetheless accords a marital privilege to promote family harmony. Similarly, the law does not require a client to confide in his attorney, but it nonetheless accords an attorney-client privilege to promote the effective assistance of counsel. The majority's privilege for accountants may be the first instance of a court creating a privilege to facilitate compliance with duties already imposed by law.[7]

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[7] The majority suggests that the Supreme Court in *Upjohn Co. v. United States*, *supra*, 449 U.S. at 393 n.2, 101 S.Ct at 684 n.2, has discounted the significance of a legal obligation of communication and disclosure in determining the scope or existence of a privilege. The footnote in *Upjohn* replied to the argument that the corporate client had an incentive to consult with its attorney and therefore did not need an

For all of these reasons,[8] I respectfully dissent from the judicial creation of an accountant's work-product privilege to insulate tax accrual work papers from the scope of § 7602.

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attorney-client privilege broader than the "control group" test. In declining to restrict an existing privilege because the client had an *incentive* to communicate, the Court had no occasion to assess whether a *legal obligation* to disclose conclusions (here, contingent liabilities) should be ignored in determining whether to create a new privilege to protect underlying details (here, questionable tax items).

[8] An additional reason advanced by the majority for favoring an accountant's work-product privilege is to prevent the I.R.S. from obtaining "backdoor" implementation of the suggestion of former I.R.S. Commissioner Jerome Kurtz that taxpayers should flag their questionable tax items. Kurtz, et al., *Discussion on "Questionable Positions,"* 32 Tax Law. 13, 15-16 (1978). Whether or not the I.R.S. can or should add such a sweeping self-questioning feature to the self-reporting tax system is fairly debatable. But once the I.R.S. has decided to devote its limited resources to an audit or investigation of a particular taxpayer, it should not be obstructed from concentrating its efforts on questionable items nor barred from identifying such items either by inquiry of the taxpayer and his accountant or, more profitably, by inspection of relevant documents.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

Nos. 81-6048, 81-6056

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of April one thousand nine hundred and eighty-two.

Present:

HON. WILFRED FEINBERG, CH.J.

HON. WALTER R. MANSFIELD

HON. JON O. NEWMAN

UNITED STATES OF AMERICA, PETITIONER-APPELLEE,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT-APPELLANT,
AND AMERADA HESS CORPORATION,
INTERVENOR-RESPONDENT-APPELLANT

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in part and reversed in part in accordance with the opinion of this court.

A. DANIEL FUSARO,
Clerk

By: ARTHUR HELLER,

Deputy Clerk

A TRUE COPY
A. DANIEL FUSARO, CLERK

By: FRANCIS X. GINDHART

Chief Deputy Clerk

Filed in U.S. District Court, S.D. N.Y. July 7, 1982

APPENDIX D

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 22nd day of June, one thousand nine hundred and eighty-two.

UNITED STATES OF AMERICA, PETITION-APPELLEE,

v.

ARTHUR YOUNG AND COMPANY, RESPONDENT-APPELLANT,

AND

AMERADA HESS CORPORATION,
INTERVENOR-RESPONDENT-APPELLANT.

NOS. 81-6048, 81-6056

FILED JUNE 22, 1982

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the petitioner-appellee, United States of America,

Upon consideration by the panel that heard the appeal, it is

ORDERED that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge on the panel that heard the appeal and that no such judge has requested that a vote be taken thereon.

A. DANIEL FUSARO,
Clerk

By: FRANCIS X. GINDHART

Chief Deputy Clerk

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 7601. CANVASS OF DISTRICTS FOR TAXABLE PERSONS AND OBJECTS.

(a) *General Rule.*—The Secretary shall, to the extent he deems it practicable, cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed.

SEC. 7602. EXAMINATION OF BOOKS AND WITNESSES.

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized—

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

SEC. 7604. ENFORCEMENT OF SUMMONS.

(a) *Jurisdiction of District Court.*—If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which such person resides or is found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, records, or other data.

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